VZCZCXRO1002
RR RUEHVK
DE RUEHUL #0096/01 0210232
ZNR UUUUU ZZH
R 210232Z JAN 09
FM AMEMBASSY SEOUL
TO RUEHC/SECSTATE WASHDC 2967
RUCPDOC/USDOC WASHDC 8023
RUEATRS/DEPT OF TREASURY WASHDC
RUEHRC/DEPT OF AGRICULTURE WASHDC
RHEBAAA/DEPT OF ENERGY WASHDC
RUEAUSA/DEPT OF HHS WASHDC
RHEHNSC/NSC WASHINGTON DC
RUEHKO/AMEMBASSY TOKYO 5285
RUEHBJ/AMEMBASSY BEIJING 5178
RUEHGP/AMEMBASSY SINGAPORE 6182
RUEHHK/AMCONSUL HONG KONG 3780
RUEHSH/AMCONSUL SHENYANG 3909
RUEHVK/AMCONSUL VLADIVOSTOK 1585
RUEHIN/AIT TAIPEI 2931

UNCLAS SECTION 01 OF 03 SEOUL 000096

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD KS
SUBJECT: SOUTH KOREA ECONOMIC BRIEFING - JANUARY 2009

In This Issue

Domestic Economy

- ROKG Adopts Expansionary USD 219 Billion 2009 Budget; Accelerates Spending
- ROKG Cuts Taxes to Revitalize Consumption and Investment
- ROKG Real Estate Reforms
- President Lee in New Year's Message Puts ROKG on Emergency Footing on Economy

Finance and Structural Policies

- Financial Authority Modifying Accounting Rules for Foreign Exchange Conversion
- Korea's FX Reserves Rise Slightly in December, Stay above USD 200 Billion
- Financial Authorities Provide Tens of Billions in Foreign Currency Liquidity
- Financial Authorities Indemnify Financial Institutions/Employees
- Banks Set Rules for Restructuring of Shipbuilding and Construction Firms
- Bank Capital Expansion Fund to Be Launched in January
- BOK Agrees to Provide Support to Bond Market Fund

Domestic Economy

¶1. (U) ROKG Adopts Expansionary USD 219 Billion 2009 Budget; Accelerates Spending: The National Assembly approved the 2009 Budget and Public Fund Operations Plan on December 13, providing an overall budget of 284.5 trillion won (USD 219 billion) -- USD 157 billion for government accounts and USD 62 billion for public funds. The overall total is 10.6 percent higher in won terms than in 2008. The government also intends to spend more than 60 percent of the major projects budget in the first six months of 2009 in order to drive private sector consumption and investment. The cabinet began approving expenditures as early as December 16 with an 11.7 trillion won (USD 9 billion) budget allocation -- USD 3.2 billion to increase capital of state-run financial companies, USD 5.4 billion for infrastructure projects and USD 0.4 billion for creating jobs. In another move to signal heavy early spending, the ROKG allocated another 3.71 trillion won (USD 2.8 billion), 1.3% of the national budget on January 2, the first day of the new fiscal year. The biggest portions of the money were used to inject USD 1.1 billion won into five state-run financial institutions and USD 450 million

into state credit guarantee institutions to provide more liquidity for SMEs and exporting firms, purchase non-performing loans and provide stability for the housing market.

¶2. (U) ROKG Cuts Taxes to Revitalize Consumption and Investment: In response to the financial crisis, the government implemented individual and business tax cuts in November and December valued at approximately 35 trillion won (USD 26.9 billion) through 2012, including 6 trillion won (USD 4.6 billion) in 2008 and 13 trillion won (USD 10 billion) in 2009. Taxes on auto sales have been cut by 30 percent for sales between December 19 and June 30, 2009. In addition, tax deductions for short-term investments will be extended through the end of 2009 -- 10 percent in provincial areas and three percent in greater Seoul. The ROKG has expanded the scope of private sector investment in public infrastructure qualifying for favorable tax treatment from roads and bridges to include railways and harbor construction. The volume of such private sector investment is projected to reach 20.8 trillion won (USD 15.4 billion) in 2009, up from 7.7 trillion won (USD 7 billion) in 2008. A 20 percent tax deduction for investment will be given for the construction of solar cell manufacturing plants. The ROKG is working to ensure all tax reduction acts revised in December will be put into effect by the end of January.

¶3. (U) ROKG Real Estate Reforms: To stimulate drooping demand for housing, the Ministry of Strategy and Finance on December 9 reduced for the next two years heavy capital gains taxes on family owning more than one house. Previously, those who own two units were required to pay 50 percent capital gains taxes when selling the first unit. The new rates will range between 6 and 33 percent. The government's passage of the of the revised Comprehensive Real Estate

Tax bill on December 13 cuts the real estate tax rate from 1-3 percent to 0.5-2 percent. This and other changes will cut the real estate tax burden on homeowners by up to 50 percent. Additionally, owners of a single home in provincial areas will be exempt from the comprehensive real estate tax, regardless of the home's value.

¶4. (U) President Lee in New Year's Message Puts ROKG on Emergency Footing on Economy: In his New Year message, President Lee Myung-bak put his administration on an emergency footing to deal with the economic situation. The president pronounced four major guiding principles in running state affairs in 2009 -- fighting the economic crisis, caring for citizens, implementing economic reforms, and implementing the green growth agenda, also known as the "Green New Deal". Lee promised the government will undertake all necessary measures (including accelerating spending, cutting taxes, and easing regulatory burdens) to mitigate the credit crunch and revitalize investment. Lee called for 70,000 internships for young people and expansion of the social safety net to help families affected by the crisis. He reiterated his green growth strategy focusing on three new growth engines -- green technology industries, industries using multiple green technologies and high value-added services -- as well as revitalizing the country's four major rivers as a multi-purpose project, which the President believes can generate 280,000 new jobs.

Finance and Structural Policies

¶5. (U) Korea's FX Reserves Rise Slightly in December, Stay above USD 200 Billion: Korea's official foreign reserves at the end of December 2008 amounted to 201.2 billion dollars, increasing USD 700 million from USD 200.5 billion at the end of November. This increase was mainly attributable to a sharp rise in operating profits on the foreign reserves and a large increase in the U.S. dollar translation value of non-dollar-denominated assets, as the dollar fell against most currencies in December. The appreciation of these assets more than offset the foreign exchange authorities' sustained supply of foreign currency liquidity to ease turmoil in the local foreign currency funding market amid the global credit crunch. Korea's official foreign reserves consist of USD 180.38 billion of securities (89.6%), USD 20.10 billion of deposits (10.0%), USD 582 million of IMF reserve position (0.3%), USD 86

million of Special Drawing Rights (0.04%), and USD 76 million of Gold (0.04%).

¶6. (U) Financial Authorities Provide Tens of Billions in Foreign Currency Liquidity in Fourth Quarter: The ROKG, and the Bank of Korea (BOK) in particular, supplied foreign currency liquidity in the fourth quarter of 2008 in order to mitigate the sudden shortage of foreign currency liquidity as the global financial turmoil struck Korea. The BOK supplied a total of USD 10.22 billion to banks through six rounds of competitive currency swaps (on October 21, 28 and November 4, 11, 18, 25) using its foreign exchange reserves. These BOK actions drove the bulk of the USD 39 billion drain on foreign exchange reserves in these two months. The BOK provided another USD 10.4 billion to banks through three rounds of competitive USD loan facility auctions (on December 2, 9 and 22) using dollars from currency swap transactions with the U.S. Federal Reserve. In addition, the ROKG supplied a total of USD 5.7 billion dollars in December -- USD 3.1 billion through unsecured loans via competitive bidding and USD 2.6 billion through the Export-Import Bank of Korea -- to commercial banks to support trade finance.

¶7. (U) Financial Authorities Indemnify Financial Institutions/Employees: ROKG financial authorities decided on December 30 to indemnify financial institutions and employees against liability for risky decisions. The objective is to loosen the prevailing credit crunch to prevent further damage to the economy. Prior to the indemnification, existing law and regulatory practice could result in severe legal sanctions for mistakes. This environment has been blamed by some observers for risk-averse decision making in ROK financial institutions. The indemnification does not provide protection for intentional misconduct, gross negligence, embezzlement, and fraud. The new guidelines will cover any credit decisions through December 31, 2009.

¶8. (U) Banks Set Rules for Restructuring of Shipbuilding and Construction Firms: The Korea Federation of Banks on December 31 finalized the rules for restructuring in the shipbuilding and

construction sectors. According to the rules, the major creditor bank will review a shipbuilder or construction firm with more than 5 billion won (USD 3.8 million) in debt and foreseeable financial risk based on debt ratio, cash reserves, sales-profit ratio, and other risk factors. Following these reviews, companies will be categorized into four groups: A -- normal, B -- temporary liquidity shortage, C -- distressed, and D -- in receivership. The major creditor banks will work through the Council of Creditor Financial Institutions by proposing a financial support and restructuring process for each respective company. The seven-member Creditor Financial Institutions Steering Committee will mediate cases in which opinions diverge in the Council of Creditor Financial Institutions. The Committee members are appointed by the Korea Federation of Banks (KFB), the Asset Management Association of Korea (AMAK), the Korea Chamber of Commerce and Industry (KCCI), the Korean Institute of Certified Public Accountants (KICPA), the Korean Bar Association (KBA), and an association of insurance companies. Policy guidance for this process was disseminated by the Financial Services Committee and Financial Supervisory Service on December 9. Note: After the initial effort failed to identify any firms requiring receivership, banks announced on January 20 that two firms, Daeju Construction and C&Heavy (shipbuilder), would be removed from the market. An additional 11 construction firms and 3 shipbuilders will undergo debt rescheduling and other efforts to restructure.

¶9. (U) Bank Capital Expansion Fund to Be Launched in January: On December 26, the Financial Supervisory Service described consultations between the BOK and the financial authorities on the anticipated launch of a "bank capital expansion fund" of 20 trillion won (USD 15.4 billion) in January 2009. The Fund is a temporary scheme to boost Korean banks' effort to raise capital and will be terminated by the end of 2009. The seed capital to establish the fund will come from the BOK (USD 7.7 billion in loans), institutional investors (USD 6.1 billion), and the Korea Development Bank (USD 1.5 billion). The BOK was reportedly working to develop ways to supply funds that would not contravene the Bank of Korea

Act. The fund is not envisaged as obligatory for commercial banks.

¶10. (U) BOK Agrees to Provide Support to Bond Market Fund: Pressed by public opinion and other financial authorities, the Bank of Korea decided on December 24 to provide a backstop asset purchase capability for the Bond Market Stabilization Fund (BMSF). The BOK decision covers asset purchases of up to 5 trillion won (USD 3.8 billion) on the 10 trillion won (USD 7.6 billion) fund in case bond-issuers default. Investors include banks, insurance companies, and securities companies. The primary purpose of the fund is to provide liquidity to quality corporations that are experiencing temporary liquidity shortages due to the current market credit crunch. The issuers will be requested to make restructuring efforts when necessary. The Financial Services Commission (FSC) and the Financial Supervisory Services (FSS) are supervising operations to ensure investor protection and market stability. Early reports indicate that the BMSF has invested primarily in state bonds or highly rated securities, eschewing riskier corporate bonds.

¶11. (U) Financial Authority Modifying Accounting Rules for Foreign Exchange Conversion: On December 19, the Financial Services Commission (FSC), the Financial Supervisory Service (FSS), and the Korean Accounting Standards Board (KASB) have agreed to implement new accounting standards for foreign exchange conversion in the annual reporting of firms for 2008. The complicated changes basically allow firms experiencing paper losses from foreign exchange conversion to minimize financial burdens in annual reports except for those resulting from derivative financial instruments. The KASB will review the situation in 2009 and determine whether to extend the arrangements into 2009.

STEPHENS